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COMMENTARY

Currency Manipulator?

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China's president, Hu Jintao, on his first visit to the U.S., may well puzzle over his host's government's sometimes obscure and legalistic approach to international economic issues. Section 3004 of Public Law 100-418 requires that the secretary of the Treasury assess whether countries such as China that have global current account surpluses or large bilateral trade surpluses with the U.S. are manipulating their exchange rates to prevent effective balance of payments adjustment or to gain an unfair competitive advantage in international trade.

The question of whether the beleaguered treasury secretary, John Snow, is willing to classify China as a "currency manipulator," with unspecified economic sanctions to follow if he does, is the current serious flashpoint in China-U.S. relations. Unfortunately, U.S. lawmakers and many, if not most, economists fail to understand that China's motivation for pegging its exchange has been to secure internal monetary stability and not to achieve an undue mercantile advantage in world export markets. The law as written mistakenly presumes that current account surpluses are per se evidence of currency manipulation by the foreign countries in question.

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Without a doubt, China's trade surpluses are large and possibly getting larger. From 2000 to 2004, China has had the world's largest bilateral trade surplus with the U.S. But since then, the collective trade surpluses of the oil-exporting countries have become larger than China's surplus. The key difference, however, is that China is a major exporter of manufactured goods that sometimes compete with U.S. manufactures, whereas imports of oil and natural gas are viewed as vital inputs for American industry. This difference explains the current concern in the Congress with possible "unfair" competition from China but not from oil exporters despite their proportionately larger surpluses. Still. China's current bilateral trade surplus with the U.S. is about one-quarter of America's huge and growing trade deficit, which is about 7% of U.S. GDP so far in 2006.

Section 3004 fails to recognize that persistent trade surpluses in China and trade deficits in the U.S. reflect very high saving in China and unusually low saving the U.S., an imbalance that no exchange rate change can correct. China's saving is even higher than its own extraordinarily high domestic investment of 40% of GDP, whereas saving in the U.S. is very low relative to a more normal level of domestic investment of 16% to 17% of GDP. The result is that China (like many other countries in Asia) naturally runs an overall current account surplus while the U.S. runs a current account deficit.

This large current account deficit -- more in goods than in services -- reflects borrowing from the rest of the world to cover its saving deficiency. Without this saving transfer allowing the U.S. to spend more on goods and services than it produces, the U.S. would suffer a credit crunch. Interest rates would increase so that investment -- both industrial and residential -- would fall. If this cessation of net foreign lending to the U.S. happened suddenly causing the current account deficit to fall quickly, and if there was no correction in America's saving deficiency, the U.S. economy would be forced into a sharp cyclical downturn similar to the "credit crunch" of 1991-92. On the other hand, if reduction in net foreign lending was gradual and spread over many years, the cost would be that America's longer term economic growth would slow as domestic investment and the current account deficit fell in tandem as a proportion of GDP.

Two main points must be recognized. First, an exchange rate change cannot correct America's current account and saving-investment imbalance. Second, if the saving rate in the U.S. were to increase gradually through time, then its current account deficit would gradually diminish -- without requiring any substantial change in nominal dollar exchange rates with major trading partners including China.

Increased U.S. saving must come from two sources: the federal government and the household sector. (U.S. corporate saving from retained profits remains robust.) Strenuous efforts must be made reduce the U.S. federal fiscal deficit, which at 3% to 4% of GDP, is a terrific drain on national saving. Tax revenues have fallen to an unduly low level by international standards. Dealing with deficient, perhaps negative, household saving is conceptually a much trickier problem. But some program of "forced" saving, from a national pension plan above and beyond Social Security contributions, should be considered. Singapore's Provident Fund could be a good model.

However, suppose the U.S. current account deficit is misdiagnosed as an exchange rate problem as with Section 3004. More than 20 years ago, when Japan had the largest bilateral trade surplus with the U.S., the U.S. government exerted continual pressure on Japan to appreciate the yen. Indeed, the yen went all the way from 360 to the dollar in 1971 to peak out at just 80 to the dollar in April 1995. This induced a bubble in Japanese stock and land prices in the late 1980s, which collapsed in 1991. A deflationary slump and a zero interest liquidity trap followed resulting in Japan's "lost decade" of the '90s. But the higher yen led to no obvious reduction in Japan's trade surplus as a share of its slumping GDP. The fall in domestic imports from the sluggish economy offset the reduced growth in Japan's exports from the higher yen.

Could the same thing happen to China? From 1994 through to July 21, 2005, China had fixed its exchange rate at 8.28 yuan per dollar by focusing its national monetary policy on maintaining that rate. The idea was to use the dollar exchange rate to anchor China's price level at a time when great financial transformation made domestic monetary indicators difficult to interpret. And this policy was successful in ironing out China's previous "roller coaster ride" in domestic price inflation and growth rates. Its high inflation of the mid 1990s came down and converged to that in the U.S. -- as the principle of relative purchasing power parity would suggest.

Now China has come under great pressure -- mainly from the U.S. -- to appreciate the renminbi. Since July 21, 2005, the renminbi has appreciated slowly -- only about 3.5% so far. But Section 3004 is an important part of continuing American political pressure on China for further appreciation. In 2006, China's year-over-year CPI inflation has fallen to just 1%, whereas America's is over 3%. Clearly, any substantial further appreciation will push China into a situation where its CPI begins to fall. To be sure, China's real economy remains robust. But if it is continually forced to appreciate the renminbi because bad economic theory suggests that a higher renminbi will eventually reduce its trade and saving surplus, the possibility of a Japanese-style deflationary slump cannot be ruled out.

So, in an ideal world, on what basis should Presidents Hu and Bush agree to reduce the trade imbalance between the two countries? China needs to increase private consumption in order to reduce its saving glut -- and its new five-year plan, which in its newly marketized economy can only be indicative, points in this direction. But the U.S. needs to drastically rein in the federal budget deficit in order to reduce the national saving deficiency. If China keeps its side of the agreement but the U.S. does not, then China's reduced trade surplus, i.e., less lending to the U.S., will mean higher interest rates here and abroad. But, whether or not such a broad agreement is implemented, Secretary Snow's narrower job of interpreting Section 3004 is straightforward: China is not a currency manipulator and the yuan/dollar rate is best left more or less where it is.

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